BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the.Appeal of)
)
'WILLIAM R. AND MAY R. HORN)

Appearances:

For Appellant William R. Horn:	H. Roy Jeppson, Attorney at Law
	Joel S. Marcus, Attorney at Law
For Appellant May R. Horn:	Jay R. Saltsman, Attorney at Law
For Respondent:	John A. Stilwell, Jr. Counsel

O P I N I O N

These appeals are made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of William R. Horn and May R. Horn against proposed assessments of additional personal income tax as follows:

Year	Proposed Assessment
1970 (William R. Horn)	$1,358.20
1971 (William R. Horn)	3,116.18
1972 (William R. and May R. Horn)	140.68
1974 (William R. and May R. Horn)	1,035.94

William R. and May R. Horn have separately filed appeals in this case. However, May R. Horn is involved in this action solely because she filed joint returns with her then'husband, William R. Horn, for 1972 and 1974. For convenience, "appellant" will hereinafter refer to William R. Horn.

The question presented is whether periodic withdrawals by appellant from his 90 percent owned corporation were loans rather than taxable dividends.

Appellant is the owner of 90 percent of the outstanding stock of Caltex Engineering Company (Caltex), a California corporation. He also is the president of Caltex. During taxable years 1970 through 1974, appellant made regular and periodic withdrawals from Caltex. Single withdrawals involved amounts from $195.84 to $25,200.00, with the majority of the withdrawals being between $750.00 and $1,000.00. Appellant withdrew these amounts several times each year, and on some occasions, several times each month. The breakdown of the withdrawals, by years, is as follows:

Taxable Year	Amounts Withdrawn
1970	$13,587.37
1971	37,252.26
1972	5,985.16
1973	33,600.00
1974	14,389.39

The record shows that Caltex's Board of Directors did not authorize any loans to appellant and that appellant executed no notes when the withdrawals were made. Furthermore, no provision was ever made for a repayment due date or repayment schedule as to any of the withdrawals. During the years in issue appellant did not repay any portion of the withdrawals. Hence, the balance of the withdrawal account increased steadily over the period under review.

It is also apparent that no collatoral for the withdrawals was ever required or posted, and that Caltex paid no dividends during any of the years on appeal even though it had significant earnings and profits as is disclosed by the following schedule:

Income Year Ended	Earnings and Profits
6/30/70	$11,071.00
6/30/71	55,190.00
6/30/72	51,128.00
6/30/73	53,536.00
6/30/74	65,716.00
6/30/75	99,612.00

The amounts withdrawn were, however, carried on Caltex's books under an account entitled "Notes Receivable, W. R. Horn." Appellant has submitted copies of corporate records indicating that interest on that account was accrued at the rate of seven and one-half percent per annum. He states that Caltex reported the interest on its tax returns and that the withdrawals were recorded as loans on financial statements used by the corporation for the purpose of obtaining credit. Furthermore, the records submitted show that on December 30, 1970, and September 30, 1971, appellant made payments of $435.32 and $1,272.68, respectively, for "accrued interest." These same records also show that in December 1970, appellant withdrew from the corporation a total of $3,000.00 ($500 of which he withdrew on December 30, 1970); and in September 1971, he withdrew a total of $2,000.00.

The evidence also discloses that at some time during the first-half of 1974, Caltex employed a certified public accounting firm to be its internal auditor. On June 30, 1974, appellant executed a promissory demand note for $92,288.36, at 7.5 percent interest per annum. (Up to that time appellant had withdrawn $96,288.00.) Also on June 30, 1974, appellant paid $15,369 to Caltex for the "interest" accrued on the withdrawal account. This payment was accomplished by Caltex issuing appellant a bonus and then applying this bonus against the accrued interest. The bonus was paid on the same day the "interest" payment was made and it matched the amount of accrued interest exactly. No money changed hands in the transaction.

On August 31, 1974, Caltex transferred appellant's note to Geronimo Service Company (Geronimo) in exchange for promises and notes with a combined face value of $96,288, $4,000 more than the face value of appellant's note. In exchange for the note, Geronimo (1) cancelled a $40,000 note payable by Caltex to Geronimo; (2) became the promisor of a new $38,788 note payable to Caltex; and (3) became the promisor (in place

of Caltex) of a $17,500 note payable to Gateway Service Company (Gateway). Gateway is a California corporation of which appellant owned 95 percent of the stock, and Geronimo is owned and operated by appellant's brother.

On September 23, 1975, appellant assigned to Geronimo all his interest in two promissory notes payable to appellant by Key-II Industries (Key-II), in the amounts of $15,000 and $25,000. This assignment was made in partial payment of the amount due on appellant's $92,288.36 Caltex note.

Information available indicates that appellant owned 40 percent of Key-II at the time those notes were executed and that the Key-II notes, on their face, were payable within 30 and 60 days, respectively, from March 28, 1973, the date they were executed. However, there is no evidence that either appellant or Geronimo ever sought to collect the amounts due on the Key--II notes. Furthermore, appellant assigned the Key-II notes to Geronimo at approximately the same time as respondent initiated the audit of appellant's records.

On December 31, 1975, the Key-II notes were partially paid by the transfer of 447,767 shares of Key-II stock to Geronimo. No evidence has been provided to show the fair market value of the Key-II stock transferred. Also on December 31, 1975, appellant paid $35,000 to Geronimo by check.

On the basis of the foregoing, respondent determined that the withdrawals in question constituted taxable dividends. Respondent issued notices of proposed assessment increasing appellant's income accordingly, Appellant protested, taking the position that the withdrawals represented loans. After due consideration of appellant's protest, respondent affirmed its proposed assessments, resulting in this appeal.

The question of whether appellant's shareholder withdrawals are to be characterized as dividends or loans depends on all the facts and circumstances surrounding the transactions between him and the corporation. (Harry E. Wiese, 35 B.T.A. 701, affd., 93 F.2d 921 (8th Cir. 1938), cert. den. 304 U.S. 562 [82 L.Ed 15291 (1938), reh. den. 304 U.S. 589 [82 L.Ed. 1549] (1938); Elliot J. Roschuni, 29 T.C. 1193 (1958), affd., 271 F.2d 267 (5th Cir. 1959), cert. den., 362 U.S. 988 [4 L.Ed.2d 10211 (1960); Carl L. White,

17 T.C. 1562 (1952); C. F. Williams ¶ 78,306 P-H Memo. T.C. (1978); Appeal of Albert R. and Belle Bercovich, Cal. St. Bd. of Equal., March 25, 1968.) Specifically, the question is whether at the time of each withdrawal there existed an intent by the shareholder to repay the loan and by the corporation to enforce the obligation. (Commissioner v. Makransky, 321 F.2d 598 (3rd Cir. 1963); Clark v. Commissioner, 266 F.2d 698 (9th Cir. 1959); Jack Haber, 52 T.C. 255 (1969), affd., 422 F.2d 1985th Cir. 1970). Furthermore, special scrutiny of the situation is invited where the withdrawer is in substantial control of the corporation (Jack Haber, supra; William C. Baird, 25 T.C. 387 (1955); W. T. Wilson, 10 T.C. 251 (1948), affd. sub nom. Wilson Bros & Co. v. Commissioner, 170 F.2d 423 (9th Cir. 1948); Ben R. Meyer, 45 B.T.A. 228 (1941)), and withdrawals under such circumstances are deemed to be dividend distributions unless the controlling stockholder can affirmatively establish their character as loans. (W. T. Wilson, supra.)

Appellant's position that the withdrawals in question were loans, and in support thereof he points to his payments of interest, his financial ability to repay the withdrawals, the adherence to certain corporate formalities, and the payments to Geronimo. For the reasons discussed below, we believe he attaches more weight to these criteria than they deserve.

The interest payments are said to be indicative of the fact that appellant and the corporation viewed the withdrawals as loans. We disagree. It is clear that the payments were of little or no consequence when it is observed that the first two of them were completely offset by withdrawals made at or about the same time the payments were made, and the third payment was paid by means of a bonus, a method critcized and accorded little weight in Ralph E. Cruser, ¶ 61,060 P-H Memo. T.C. (1961). Moreover, even the significance of bona fide interest payments is nullified where, as here, withdrawals exceeded payments in each of the years at issue. (Ben R. Meyer, supra.)

Appellant also raises the fact that he always had the ability to repay and argues that this evidences the withdrawals were loans. We conclude otherwise for the fact is that appellant made no repayment during the years at issue and offered no credible explanation of why he did not do so. (See George R. Tollefsen, 52 T.C. 671 (1969).) Furthermore, without further explanation,

his ability to repay at all times is inconsistent with Caltex's seeking of bank financing instead of having appellant repay what he had withdrawn.

Under the category of corporate formalities, appellant points out that he executed a note, a generally accepted indicator that a real loan existed. We consider this individual factor to be less than significant since the promissory note was a demand instrument and it had no fixed schedule for repayment. These factors cause the note to have decreased significance as evidence of genuine indebtedness. (See Bayou Verret Land Co. v. Commissioner, 450 F.2d 850, 857 (5th Cir. 1971); see also, Estate of Taschler v. United States, 440 F.2d 72, 76 (3rd Cir. 1971).) Furthermore, the note was not executed until the end of the period under review, and an internal audit of Caltex's books immediately preceded it. Under these circumstances, the note appears-more to have resulted from post internal audit advice than from an original intention to treat the withdrawals as loans.

The remaining factors under the category of corporate formalties also contribute little to appellant's position. They include such things as the treating of the withdrawals as loans on Caltex's books, the reporting of the accrued interest on Caltex's tax returns, and the listing of the withdrawals as loans on Caltex's financial statements. These sorts of corporate -formalities, though generally indicative of a loan, are entitled to limited weight when the corporation is wholly owned or controlled by the taxpayer. (Regensburg v. Commissioner, 144 F.2d 41 (2d Cir. 1944); Ben R. Meyer, supra; Daniel Hunt, Sr., 6 B.T.A. 558 (1927).) Since appellant controls Caltex, we are not convinced that an intention to repay the withdrawals is manifested by the corporate formalities cited herein.

Limited weight attaches as well to the fourth factor cited by appellant, his payments to Geronimo. First, his attempts at repayment were made more than five years after he made the first withdrawal. Second, the repayment efforts were made only after respondent had notified him of its intention to audit his records. These circumstances go far to weaken the "repayments" as persuasive evidence of a pre-existing intention to repay the amounts withdrawn. (Atlanta Biltmore Hotel Corp. v. Commissioner, 349 F.2d 677, 680 (5th Cir. 1965).) Furthermore, as regards the value of the "repayments,"

neither the Key II notes nor the Key II stock has been shown to have had any market value whatsoever.

From the above it can be seen that appellant's position is considerably less meritorious than he advances, and on this basis alone, it appears he has failed to carry his burden of showing that the withdrawals were loans rather than dividends. Nonetheless, there exists even more reason to sustain the respondent in this matter. It is known that appellant owns practically all of the stock of Caltex and is the president of the corporation. There is, therefore, no doubt that he controls Caltex. The record also shows a steady pattern of substantial withdrawals from the corporation. The withdrawals were apparently for his personal use and there was no stated ceiling on the amount that he could withdraw for such personal uses. Furthermore, appellant executed no indicia of debt when he made the withdrawals and there was never any date specified for repayment of the withdrawals. Finally, Caltex failed to pay a formal dividend for any of the years at issue, notwithstanding the fact that in each of those years Caltex had ample earned surplus from which to pay dividends. In the Appeal of Albert R. and Belle Bercovich, supra, we held that the immediately preceding characteristics supported the conclusion that shareholder withdrawals in that case were dividend distributions rather than loans. We agree that they support the same conclusion in the instant matter.

In summary, there is no question in our minds that the withdrawals at issue were taxable corporate distributions instead of bona fide loans. This determination is not affected by the cases cited by appellant, for each of those cases is distinquishable from the instant case. Harry Hoffman, ¶ 67,158 P-H Memo. T.C. (1967), for example, involved repayments so substantial and frequent that in some of the years involved, repayments exceeded withdrawals; Carl L. White, supra, involved a minority shareholder, constant repayments in the thousands of dollars, and the pledge of the taxpayer's stock as security; In re Ward, 131 F.Supp. 387 (D.C. Colo. 1955), concerned substantial and timely repayments; A. J. Dalton, ¶ 57,020 P-H Memo. T.C. (1957), was based on substantial repayments and the corporation's payment of a significant amount of dividends; Edwards Motor Transit Co., ¶ 64,317, P-H Memo. T.C. (1964), involved the substantial repayment of amounts advanced, the existence of a "business purpose" for the advances, and the payment of formal dividends;

and in Harry E. Weise, supra, the taxpayer argued that his withdrawals were dividends. Inasmuch as these cases are distinguishable from the instant case, they cannot be considered to lend any support to the position taken by appellant.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of William R. Horn and May R. Horn against proposed assessments of additional personal income tax as follows:

Year	Proposed Assessment
1970 (William R. Horn)	$1,358.20
1971 (William R. Horn)	3,116.18
1972 (William R. and May R. Horn)	140.68
1974 (William R. and May R. Horn)	1,035.94

be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of May, 1981, by the State Board of Equalization, with all Board members present.

Ernest J. Dronenburg, Jr., Chairman

George R. Reilly, Member

William M. Bennett, Member

Richard Nevins, Member

Kenneth Cory, Member